FALL 2023 EDITION

PRESENT VALUE

Alternative Credit Newsletter

Welcome to the inaugural edition of "Present Value," your premier source for the latest developments and insight within the ever-evolving world of private credit. In this issue, we delve into the drivers of private credit and how Chesswood Capital Management fits into this growing asset class. For a primer on the asset class, please refer to our White Paper.

What is driving Private Credit?

“A bank is a place that will lend you money if you can prove that you don’t need it!”
- Bob Hope

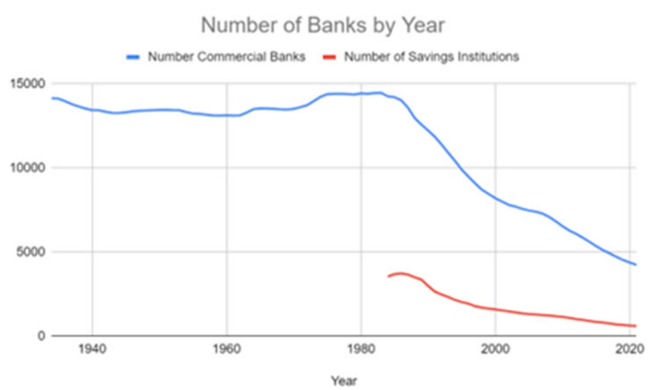
The banking and financial services industry has a habit of complicating relatively straightforward concepts. Private credit, at its core, is not a difficult concept. It refers to funding from sources not defined by regulators as “public lending institutions” (banks, mortgage companies, credit card companies, etc.). In other words, a private lender is any individual or organization loaning money outside the traditional financial services industry. Chesswood has been in the asset-backed private credit lending business for more than 30 years, with over $17 billion in credit originated since going public, but it is only over the last decade that we have seen private credit boom as an asset class. There are a variety of reasons, including:

- The number of publicly traded companies has plummeted by almost 60% since 1995, with more companies staying private for longer. While going the public route offers more liquidity, it also introduces regulatory burdens; and the role played by algorithmic and high velocity trading, along with retail investing, creates volatility in terms of cost of equity capital.

Chesswood
Capital Management

Source: World Bank

- Due to decades of bank consolidation, regulation and changing regulatory frameworks, the number of banks in the United States has fallen from almost 15,000 in 1980 to approximately 4,200 today. Furthermore, post the Great Financial Crisis (GFC) of 2008-2009, banks are having to adhere to more stringent capital ratios, further limiting lending flexibility, with a focus on prime credits. Increasingly, banks have focused their lending activities on real estate, consumer banking and working with larger corporations. Earlier in 2023, we witnessed considerable consolidation in regional banking, with more expected going forward, encouraged, in many cases, by the regulator.



Source: United States FDIC

- In North America, 99% of companies with 100 employees or more are private and represent about 1/3rd of economic output. Thirty million businesses with revenues of less than $10 million are facing credit availability challenges, as evidenced by the NFIB small business surveys. The traditional channels for these customers, including regional banks, are under financial and regulatory pressures, which has limited the appetite to lend, opening up opportunities for private credit lending.

Source: Bloomberg

- The banking sector is expected to face further scrutiny from regulators, which may further both consolidation and the necessity to hold more capital on balance sheet. As of the end of the second quarter of 2023, unrealized losses of fixed income holdings were ~US$600 billion. Smaller banks and credit unions are contracting credit in a number of sub-sectors, and specifically CRE (commercial real estate).

Source: FDIC, Apollo

Where does Chesswood fit in?

Chesswood participates in the US$1.14 trillion equipment finance market, with the Canadian counterpart being approximately $140 billion. Nearly 6 in 10 North American companies use some form of financing when acquiring equipment, including loans, leases and lines of credit.

Chesswood Capital Management

Of the US$2 trillion, that US businesses and government agencies invest in capital goods and software annually, 57.3%, or $1.16 trillion, is financed through loans, leases and other instruments.

The most financed equipment types include:

1) Transportation
2) IT and Related Technology Services
3) Construction
4) Agricultural
5) Industrial/Manufacturing

According to the Equipment Leasing and Finance Association (ELFA), banks and captive finance firms hold a 63% and 31% share of the market, respectively, with independents such as Chesswood at just 6%. As banks/captives either stagnate or retrench within some of these markets, the greenfield opportunities for the likes of Chesswood are considerable. Within both the US and Canadian markets, Chesswood is currently one of the largest independent originators of small-ticket equipment loans and leases.

Small-ticket ($25,000-$250,000 per transaction) asset-backed lending comprises approximately 39% of the US market, or $507 billion, with automotive lending of approximately $250 billion, and the remainder being machinery/ industrial and non-auto transportation.

Since small-ticket equipment leasing and finance transactions generate solid asset yields with stable and manageable credit-quality costs, there has been steady consolidation. Mergers and acquisitions within this market sub-segment have been material, as evidenced by the 2016-2020 list alone.

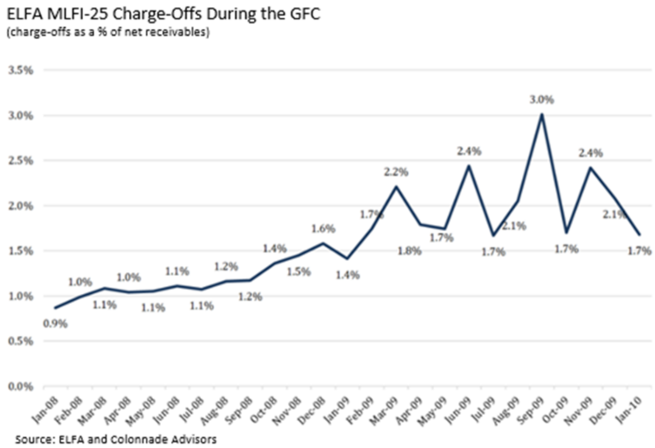
Larger banks have been largely absent from small-ticket asset-backed lending due to lack of expertise, their relatively high overhead vs average transaction size and limited risk appetite.

Small-Ticket Equipment Finance Consolidation

Date	Buyer/Investor	Target
22-Jan	HPS Investment Services	Marlin Business Services
21-Oct	Chesswood Group Ltd.	Rifco Inc.
21-Apr	Chesswood Group Ltd.	Vault Credit Corporation
20-Apr	Regions Bank	Ascentium Capital
20-Mar	Alliance Funding	Pinnacle Capital Partners
19-Nov	Tokyo Century	Allegiant Partners Inc.
19-Sep	Kingsbridge Holdings	Technology Finance Corporation
19-Apr	TimePayment	LeaseQ
19-Jan	People's United Bank	VAR Technology Finance
18-Dec	Great Western Leasing	All Points Equipment
18-Dec	Equitable Group	Bennington Financial Equipment Finance
18-Oct	Mitsubishi UFJ	ENGS Commercial Finance
19-Sep	Marlin Business Services	Fleet Financing Resources
18-Aug	Wafra Capital Partners	North Mill Equipment Finance
18-Jul	People's United Bank	Vend Lease Company
18-Jul	Verdant Commercial Capital	Intech Funding Corp.
18-Apr	Sterling National Bank	Advantage Funding (Marubeni)
18-Jan	Canadian Western Bank	Canadian Commercial and Vendor Finance Assets of ECN
18-Jan	Copley Equity Partners	North Star Leasing
18-Jan	United Community Banks	Navitas Credit Corp.
17-Aug	Solar Capital	Nations Equipment Finance
17-Jul	People's United Bank	LEAF Commercial Capital Inc.
17-Mar	Lease Dimensions	Genpact
17-Feb	PNC Financial Services Group	ECN Capital's U.S. Commercial, Vendor Finance Business
17-Jan	Currency Capital	Lovell Minnick Partners
17-Jan	Marlin Business Services Corp	Horizon Keystone Financial
16-Dec	Radius Bank	NewStar
16-Nov	LeaseQ	Noesis
16-Oct	Hanmi Financial Corporation	Banc of California CSF Portfolio
16-Oct	Engs Commercial Finance Co.	Connext Financial, Ltd.
16-Oct	Laurentian Bank of Canada	CIT Canada
16-Oct	Warburg Pincus	Ascentium Capital
16-Aug	Platinum Equity	Electro Rent Corporation
16-Aug	TZP Capital Partners II	Kingsbridge Holdings

Source: Collonade Advisors and Chesswood Capital Management

The equipment-backed credit asset class outperformed most of its peers during the GFC. ELFA has an index of 25 leading equipment finance firms and compiled historical charge-off rates during the GFC. Losses in Equipment asset-backed securities (ABS) peaked at about 300 basis points, nowhere close to materially affecting the cash flow performance of senior securities in ABS structures. The lack of prepayment risk, relatively short duration, underlying collateral of real assets and relatively low delinquency/net charge-offs for Equipment ABS were the primary explanations for experiencing the good performance during bad times.



The appeal of these assets to both financial institutions and investors are considerable. In the case of small-ticket equipment finance and Chesswood's core business, the benefits include:

- Given the relative small size of each transaction (~$50,000 in Chesswood's case), a portfolio can contain hundreds or thousands of individual contracts. This diversification leads to more stability and lower risk over time.

- Our leases and loans are fully amortizing (average term is 48 months), meaning that every payment we receive from our borrowers includes both interest and principal – we are not concerned with refinancing risk at the end of a loan period: everyone is paying their loans to zero.

- The amortizing nature of these loans provides natural liquidity, with approximately 5-6% of a portfolio's invested capital being returned each quarter. If additional liquidity is required, these credits can also be sold off to active securitization markets, a unique differentiator among private credit.

- Payments are made monthly providing immediate feedback on the status of borrowers and performance of the portfolio.

- There is a focus on downside protection – a natural credit enhancement occurs each month as more principal is paid back – and in the case of default, the lender has the recovery value of the hard asset as further collateral in stressed scenarios. This recovery is expedited due to the standardized, legally enforceable lending contracts signed by the borrower.

We believe our small ticket equipment lending benefits portfolio risk/reward and due to low correlation with the equity market, provides an attractive complement to direct lending and other fixed income instruments.

For more information on private credit and our funds, please visit: www.waypointinvestmentpartners.com